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The Political Economy of Inflation and Stabilization in Middle-Income Countries

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and
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This paper — a product of the Macroeconomic Adjustment and Growth Division, Country Economics Department — is part of a larger effort in PRE to understand the political economy of stabilization and structural adjustment. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Aludia Oropesa, room N11-019, extension 39176 (64 pages with tables).

Drawing on case studies of 58 episodes of inflation and stabilization in 17 middle-income Latin American and Asian countries, Haggard and Kaufman analyzed the political economy of inflation and stabilization. They concluded that political factors that affect macroeconomic stability and stabilization efforts include populist movements, elections, and pressures from interest groups.

Macroeconomic stability is most precarious, they found, where the party system is fragmented or polarized, reinforcing social and economic cleavage among contending groups and exacerbating political instability. Stabilization is invariably delayed in such a setting.

Where rates of inflation are low or moderate, democratic and authoritarian governments seem equally capable of implementing stabilization policies. In this sample, virtually all high inflation was brought down only under the auspices of authoritarian regimes — underscoring the challenges facing the newly democratizing Latin American and Central European governments.

These cases suggest, however, that institutional arrangements that insulate economic decisionmaking from partisan conflict can contribute to successful stabilization under democratic auspices.

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The Political Economy of Inflation and Stabilization in Middle-Income Countries

Stephan Haggard and Robert Kaufman

In a number of middle-income developing countries, the severe inflationary crises of the 1980s coincided with political liberalization and an expansion of the arena of distributive politics. This wave of democratization raises questions that have recurred throughout the post-World War II period. To what extent do distributive conflicts among contending social groups aggravate macroeconomic imbalances? How are these political pressures affected by the party system, the nature of representative institutions and the type of political regime? Are authoritarian regimes "necessary" for bringing inflation under control in countries where the level of political mobilization and social conflict is high?

This paper provides a comparative analysis of the politics of inflation and stabilization in seventeen Latin American and Asian countries. Although we are interested in the effects of distributive conflicts generally, we pay particular attention to social movements and governments that seek to mobilize the popular sector, usually in opposition to the existing distribution of income and assets. Macroeconomic instability may also result from distributive conflicts among other regional, sectoral or ethnic groups. However, both before and during the 1980s, populist policy cycles have raised the troubling question of the relationship between populism, inflation, and the viability of democratic institutions.[1]

Section One of the paper reviews the arguments linking political constraints to macroeconomic policy and inflation, with particular attention to the role that populism might play in propagating inflation. In Section Two, we examine the inflation histories of three groups of middle-income countries: those that have maintained relatively stable macroeconomic policies over the long-run; those that have periodically experienced severe difficulties, but managed to adjust; and those that experienced recurrent cycles of very high inflation over an extended period. In Section Three, we draw more extensively on case studies of particular inflation episodes to examine the conditions under which inflation has been brought down, paying particular attention to the effect of regime type on stabilization efforts.

Three broad findings are worth underlining at the outset. First, although distributive pressures centering on populist demands have played an important role in most cases of very high inflation, populism was not a significant factor in the majority of the inflationary episodes in our sample. Many countries in which popular sector groups were weak or repressed have also experienced difficulties with inflation as a result of external shocks, policy miscalculations, elections, and distributive pressures from the middle class, bureaucracy, military, business, and state-owned enterprises. Even where organized labor and other popular-sector groups have been participants in conflicts that have inflationary consequences, their goals have usually been defensive in nature, responding to periods of wage compression or the erosion of real wages that comes from inflation itself. It is also important to emphasize that the populist policies responsible for inflationary cycles stem as much from the strategies of contending political elites as they do from the independent capacity of popular-sector groups to defend their incomes through collective action.

A second and related point concerns the importance of institutions for understanding the politics of inflation and stabilization. Although the size and organizational capacity of popular-sector groups does have an effect on the ability of governments to maintain stable macroeconomic policies, much depends on the way the party system channels group demands. Macroeconomic stability is most precarious where the party system is fragmented or polarized, thereby reinforcing social and economic cleavages among contending groups. Where partisan conflict is proscribed or where a single party dominates, governments can coopt important groups into corporatist or party structures that facilitate bargaining, lengthen time horizons, or simply limit the range of group demands. In such political settings, technocrats are also most likely to be insulated from the pull of distributive political conflicts, and have greater independence in formulating policy. More competitive constitutional systems can also sustain macroeconomic stability, but this is more likely where broad, catch-all parties mute social conflict and prevent the abrupt shifts in policy that are likely in more polarized or fragmented settings.

A third finding concerns the long-standing debate on the capacity of different political regimes to restore price stability once inflation has accelerated. Where rates of inflation are low or moderate, constitutional and authoritarian regimes seem equally able to implement stabilization policies. On the other hand, virtually all very high inflations in our sample have only been brought down under the auspices of labor-repressive authoritarian regimes, even where wage pressures were not necessarily a significant cause of inflationary pressure. This pattern suggests that regime type can have an important influence on stabilization outcomes in some political and economic settings, and underscores the particular difficulties new democracies face in controlling the rampant inflations that plague a number of Latin American countries.

Before beginning our analysis, two objections might be raised to the particular emphasis we place on the domestic political sources of inflation. It could be argued that domestic political conflict is less important for understanding inflation and stabilization than external shocks or international conflicts over the adjustment process. As will be seen, external shocks figure prominently in the following story, though countries' vulnerability to them and ability to adjust are closely related to domestic policy and politics. We also recognize that the IMF and creditors initially responded to the debt crisis by emphasizing demand management at the expense of structural adjustment and debt relief, but these issues are treated elsewhere.

Second, it can be argued that orthodox stabilization measures may be inappropriate for managing very high inflations where strong inertial forces are at work. It is also wrong to portray stabilization as an end in itself. Macroeconomic management is ultimately a tool for achieving growth objectives, and it may be acceptable to tolerate some inflation if the costs of stabilization in terms of output are high. Resistance to stabilization may thus stem not only from the play of political interests, but from substantive disagreements over development strategy, tradeoffs among different economic objectives, and the efficacy of orthodox policy prescriptions. [2]

Despite these caveats, it is clear that high inflation has proved extremely costly and that coherent demand management policies are a necessary pre-requisite for sustainable economic growth. Even where some form of "heterodox" measures are called for, they are unlikely to work in the absence of complementary "orthodox" measures. There is also increasing agreement that longer-term measures of structural adjustment will not be effective unless inflation is first brought under control. It should be clear that politics influences macroeconomic choice; exactly how is the subject to which we now turn.

I. Theories, Hypotheses, Variables

We are interested in two sets of outcomes, the first being differences in the level and variability of inflation over the long-run. Why do some developing countries have high inflation while others maintain relative price stability? And why do countries with high mean inflation rates also appear to exhibit cycles of stop-go macroeconomic policy, cycles that may be more damaging for economic activity and political stability than high levels of inflation per se?[3] Our main concern, however, is in the political economy of stabilization: how political factors affect the timing of the introduction of stabilization packages; the mix of instruments used, including the balance between "orthodox" and "heterodox" measures; and the ability to sustain stabilization objectives in the face of political resistance.

We begin by analyzing the way distributive conflicts, particularly those involving the popular sector, translate into inflation. Defining the "popular sector" poses particular difficulties, since it has been identified in part by class position, in part by employment in the import-substituting and non-traded goods sectors, in part by the urban-rural divide. Moreover, populism as a political movement encompasses groups that can have sharply conflicting interests: the urban poor, public employees, unionized industrial workers, and at times, the small manufacturing and service establishments that make up the "petite bourgeoisie." We will therefore focus on two distinct, but related, political forces. The first are political leaders, parties, or movements that seek the support of the popular sector on the basis of distributive appeals directed against high-income groups. We will also pay attention to industrial and public sector unions, since they usually form the core of movements demanding redistributions of income.

As Albert Hirschman has pointed out drily, "the explanation of inflation in terms of social conflict between groups, each aspiring to a greater share of the social product, has become the sociologist's monotonous equivalent of the economist's untiring stress on the undue expansion of the money supply."[4] Before turning to the political constraints on policy, we must therefore provide some account of the economic mechanisms through which group conflicts might be translated into inflation.

One source of inflationary pressure is cost-push. Where unions and popular sector groups are strong, whether because of government support or level of organization, wage settlements are likely to be more generous than in those countries where such groups are organizationally weak; this mechanism has been a central concern of much of the literature on the political economy of inflation in the advanced industrial states.[5] When firms are able to pass along rising labor costs through higher prices, cumulative inflationary cycles can result.[6]

The second source of inflationary pressure, and the one on which we focus our attention, is through fiscal policy. The inflationary impact of a given fiscal stance will depend on the share of bu get deficits that are financed by money creation, the size of the monetary base, and the demand for money. Nonetheless, a growing literature has documented that budget deficits financed by seignorage have played a crucial role in developing country inflation.[7]

The task for political economy is to specify the political correlates of inflationary fiscal policy. One approach is to focus directly on the presence and strength of what Mancur Olson has called "distributive coalitions."[8] The extent of urbanization and industrialization has historically been higher in the more developed Latin American countries and Turkey than it has been until very recently in the other Asian cases, and this might be a plausible indicator of the likely presence of popular sector groups. (Table 1) Inflation rates from 1960 through 1980 correlate fairly strongly with urbanization in 1960 (.61) and with industry's share of GDP in 1960 (.56). The data on labor organization and income distribution is much less reliable. Available estimates suggest more extensive unionization in Latin America than in East Asia, though the simple correlation between unionization and inflation from 1960-1980 for this sample of countries is weak (.17). Income distribution is, in general, also much more skewed in Latin America as well. This should be a good predictor of the presence of popular sector groups and populist politics, though clearly not of their success.[9]

Table 1
Social and Economic Structure and Inflation in East Asia and Latin America

	Urban Population/ Total (1960)	Industry/ GDP (1960)	Share of Labor Force in Unions (c. 1975)	Income: Lowest Fifth/ Highest Fifth	Average Annual Inflation 1965-1980	1980-1986
Argentina	71%	38%	25%	11.4	78.3%	326.2%
Brazil	45	35	na	33.3	31.3	157.1
Chile	69	38	25	11.4	129.9	20.2
Colombia	47	26	13	21.1	17.4	22.6
Costa Rica	34	19	12	16.6	11.3	32.3
Jamaica	30	38	25	na	12.8	19.8
Mexico	50	29	20	15.1	13.1	63.7
Peru	47	29	37	32.1	20.5	100.1
Uruguay	73	28	25	10.8	57.8	50.4
Venezuela	68	22	45	18.0	8.7	8.7
Mean, Latin America	53.4	30.2	25.2	18.9	38.1	80.1
Indonesia	15	17	10	na	34.3	8.9
Korea	28	19	10	7.5	18.8	5.4
Malaysia	26	18	15	16.0	4.9	1.4
Philippines	30	28	na	13.6	11.7	18.2
Taiwan	35	29	11	4.2	8.3	5.8
Thailand	13	19	na	8.9	6.8	3.0
Turkey	30	21	8	na	20.7	37.3
Mean, Asia	25.3	21.6	10.8	10.0	15.1	11.4

(Note: means are unweighted averages. Data on income distribution is from household surveys in the late 1960s or early 1970s. Industry share of GDP is probably biased upwards for the Latin American countries because of higher levels of protection.

Sources: World Bank, World Development Report 1978 (Washington D.C.: World Bank, 1978); World Bank, World Bank Development Report 1988 (New York: Oxford University Press, 1988); Republic of China, Council on Economic Planning and Development, Taiwan Statistical Data Book 1988 (Taipei: CEPD, 1988); Charles Lewis Taylor and David Jodice, World Handbook of Political and Social Indicators (New Haven: Yale University Press, 1983); Jeffrey Sachs, "Social Conflict and Populist Policies in Latin America," National Bureau of Economic Research Working Paper No. 2897 (March 1989).

There are some striking anomalies raised by this approach, however, particularly with regard to the relationship between inequality and inflation. Countries such as Chile, Argentina, and Uruguay, with long histories of both populism and inflation, do not have highly unequal distributions of income, at least by regional standards. Conversely, income is relatively concentrated in Malaysia, Venezuela and Colombia, countries with long histories of low inflation. For this sample, the simple correlation between inequality and inflation, 1960-80, is actually negative (-.23).

Part of the problem lies in the proxies for measuring the "strength" of distributional coalitions. A large industrial workforce can be weakly organized, as those in Korea and Taiwan have been until quite recently. Conversely, urban forces, including civil servants, may play a political role disproportionate to their actual numbers; this is the case in a number of low income African countries. More importantly, this method necessarily obscures the actual political processes that yield the inflationary outcome. Is an expansionary fiscal policy the unintended consequence of increased pressures for transfers, subsidies, and government patronage, the conscious result of efforts by politicians to expand output in response to various political constraints, or the effect of misguided economic strategy?[10]

Rather than this approach, we focus directly on the mechanisms through which politics influences macroeconomic policy choice. There are at least three approaches to this question: one emphasizes electoral constraints, insecurities of tenure, and political instability; one the constituent bases of governments; and one the institutional context of decision-making.

Strategic models of elections focus on the time-horizons of politicians, and assume some ability to engineer a trade-off between inflation and output.[11] In the pre-election period, incumbent governments will be sensitive to unemployment, particularly if popular sector groups are politically mobilized or simultaneously engaged in demonstrations or protests. This sensitivity is not necessarily limited to democratic governments; it may be equally acute in military regimes seeking to engineer a transition to democracy. Inflationary macroeconomic policy may thus be a product of regime changes, as well as institutionalized electoral cycles.[12]

Though this strategic view of macroeconomic policy has been used to explain recurrent cycles of output and prices, it can be expanded to explain cross-national differences in inflation over the long run. Political systems in which there are frequent elections and changes of government or ongoing challenges to the security of officeholders are likely to be ones in which the time horizons of politicians are chronically short. Such political instability can provide recurrent incentives to inflate, overvalue the currency and borrow, resulting in an inflation path that is higher than that which would occur under a more stable political setting.[13]

A second strand of analysis focuses on the orientation of the government in power. We would expect differences in the policy preferences of parties and governments to reflect different constituent bases.[14] The range of political orientations in the developing world is somewhat wider than in the advanced industrial states however, with greater representation at the extremes. We have therefore divided governments into four groups based on an assessment of their programmatic statements and political appeals. At one extreme are rightist governments that are explicitly anti-labor, anti-populist and anti-leftist (coded "1"). This category includes, but is not limited to, right-wing authoritarian regimes. These governments seek to defend the concentration of income and assets among business elites, large landowners, and upper middle-class groups, and can be expected to pursue the most conservative macroeconomic policy. Our second category (coded "2") corresponds closely to the center-right category among the advanced industrial states. Our third category (coded "3") are moderately reformist governments of the center-left, typified by the reformist Latin American governments of the 1960s that were favored by the Alliance for Progress. The final category (coded "4") consists of governments that are committed to a redistribution of income and assets toward the popular sector, and can be expected to have the most expansionist macroeconomic policies. We will call these governments "populist," though the category includes socialist experiments, such as the Allende period in Chile and the Manley governments in Jamaica as well.

While we expect the distributive orientation of the government to play an important role in determining the content of policy, we also want to explore the independent effect of institutional arrangements on macroeconomic policy. There are a number of institutional variables which may be of significance, including the independence of the central bank and the mechanics of the budgetary process.[15] We focus here, however, on the party system and the way in which it structures the representation of interests and patterns of group conflict.

We expect that the formulation of macroeconomic policy is likely to be most difficult in electoral systems in which party alignments are <u>polarized</u> or <u>fragmented</u> (coded '3'). Political polarization refers to the bifurcation of the party system into two competing blocs which define their interests in zero-sum terms. In middle-income countries, such polarization is frequently associated with the political mobilization of the urban popular sector. Fragmentation refers to a party system in which more than two major parties compete, usually as a result of electoral rules that encourage party formation, particularly proportional representation. Such rules provide incentives for the organization of ideologically-oriented parties, including those making appeals to the popular sector, though fragmentation does not guarantee their influence.

Systems dominated by catch-all parties that cut broadly across sectoral and class lines provide less scope for populist politics, and appear conducive to stable policy outcomes. (These systems are coded "2") Since unions and other popular sector groups must operate within cross-class organizations, their influence is necessarily reduced. Such electoral systems would include dominant party systems such as Malaysia and Mexico as well as institutionalized two-party systems such Venezuela, Colombia, and Uruguay prior to the military's entry into politics.

Finally, interest group influence is likely to be weakest in no-party or one-party systems. We call these systems "monist," and have coded them as "1." Again, the reasons for this expectation are empirical as much as theoretical, and may simply reflect the absence of revolutionary governments in our sample. Where political competition has been restricted in middle-income countries, however, it is frequently to limit the influence of the popular sector. The reasoning is also broader; no-party or dominant party systems will provide less political space for interest groups, including the popular sector, to organize or gain effective representation, and greater autonomy for technocratic elites.

The distinction between monist systems and others is not wholly equivalent to the distinction between authoritarian and democratic regimes. In some authoritarian system, the government has been unable or unwilling to suppress party activity, even if the rules of the political game do not allow leaders to be chosen in competitive elections. A number of authoritarian regimes have undergone periods of political polarization or fragmentation, as opposition forces have coalesced against the government's wishes or have been allowed to operate under some constraint during a period of transition to fully democratic rule.

Institutional arrangements might affect macroeconomic policy through several distinct mechanisms. Fragmented and polarized systems are likely to be associated with frequent changes of government, and it may thus be the instability of the system that yields suboptimal performance. Polarized and fragmented systems are also ones in which the policy preferences of contending parties diverge sharply. Where centrist political forces are weak, the zone of compromise between contending groups shrinks and alternations of government will be associated with wider swings in basic policy orientation. This conflict between groups with different inflation preferences might explain high variability in inflation in particular.[16]

In fragmented party systems, inflation may be the (unintended) result of coalition politics, and the need to payoff coalition partners. Where small parties hold the electoral balance, they can gain a veto over spending and taxing decisions. Similarly, it could be argued that governments in highly polarized or fragmented settings will seek to accommodate competing pressures in order to mute conflict. One way of doing this in the short-run is through expansionary fiscal and monetary policies. In the case studies that follow, we attempt to identify clearly the mechanisms through which institutional structures actually influence macroeconomic policy choice.

II. Political Sources of Inflation over the Long-run

We turn now to the politics of inflation in the middle-income countries. Table 2 provides two ways of assessing inflation histories. Mean annual inflation rates provide a picture of cross-national differences over the long run. To obtain a better picture of the variability of inflation over time, and to isolate the way political factors contribute to inflation, we have also identified various inflation "episodes" when inflation peaked over a specific threshold for a full calendar year. Peaks between 15 and 29 percent are considered episodes of "moderate" inflation, those between 30 and 89 percent are considered "high," and those over 90 percent "very high."[17] These episodes also provide the basis for identifying stabilization efforts, the subject of the following section. In this section, however, we focus on the political correlates of inflation over the long-run, using the country rather than the episode as the unit of analysis.

Both the mean annual inflation rates since 1960 and the incidence of inflation episodes, suggest three broad national inflation histories. (Table 2) One group of countries has maintained low inflation for most of the last three decades. These countries experienced inflationary pressures at various points in their histories, but usually as the result of external shocks rather than domestic politics and policies. We include in this group Malaysia, Thailand, Taiwan, and Venezuela. At the other extreme are a group of very high inflation countries that experienced recurrent and severe cycles of inflation over extended periods: Argentina, Brazil, Uruguay and Chile before the mid-1970s. The remainder of the countries have mixed records; Jamaica, Turkey, Peru, Indonesia, Korea, the Philippines, Colombia, Mexico, and Costa Rica fall into this category. These countries have either had recurrent cycles of moderate inflation or relatively severe inflations that were internally generated, but confined to short periods of time. We also include in this group countries such as Mexico and Peru which had long histories of low inflation, but have recently experienced serious and sustained inflationary pressures. We organize the discussion of the political correlates of inflation around these three distinct patterns.

Table 2
Cross-National Patterns of Inflation

	Mean Annual Inflation 1960-1980	Mean Annual Inflation 1980-1986	Inflation Episodes Year of peak inflation, inflation rate
1. Low Inflation Countries			
Malaysia	4.9	1.4	1974 (16.1)
Taiwan	8.3	5.8	1960 (18.4); 1974 (47.5); 1980 (19.0)
Thailand	6.8	3.0	1974 (24.3); 1980 (19.7)
Venezuela	8.7	8.7	1980 (21.5); 1987 (28.1)
2. Countries with Mixed Records			
Colombia	17.4	22.6	1963 (32.0); 1966 (19.1); 1977 (33.1) 1985 (24.0)
Costa Rica	11.3	32.3	1974 (30.1); 1982 (90.1)
Jamaica	12.8	19.8	1974 (27.2); 1978 (34.9); 1984 (27.8)
Mexico	13.1	63.7	1977 (29.0); 1987 (131.8)
Peru	20.5	100.1	1968 (19.0); 1975 (23.6); 1981 (75.4) 1985 (163.4)
Indonesia	34.3	8.9	1966 (1044.8); 1973 (40.6); 1978 (18.2)
Korea	18.8	5.4	1964 (29.5); 1970 (16.1); 1975 (25.3); 1980 (28.7)
Philippines	11.7	18.2	1971 (21.4); 1974 (34.2); 1980 (18.2); 1984 (50.3)
Turkey	20.7	37.3	1975 (19.2); 1980 (110.2)
3. High Inflation Countries			
Argentina	78.3	326.2	1952 (38.1); 1959 (113.9); 1966 (31.7); 1971 (61.2); 1976 (443.2); 1985 (672.1); 1987 (229.7)
Brazil	31.3	157.1	1956 (21.8); 1959 (51.9); 1964 (91.4) 1979 (52.7); 1987 (227.1)
Chile	129.9	20.2	1955 (84.0); 1959 (33.3); 1963 (45.3); 1970 (34.9); 1974 (504.7)
Uruguay	57.8	50.4	1959 (39.5); 1968 (125.3); 1973 (97.0); 1986 (76.4)

Note: Inflation is measured by change in the consumer price index. Inflation "episodes" are periods when the inflation rate crosses one of three thresholds: "moderate" inflations exceed 15 percent for a calendar year, "high" inflations exceed 30 percent, and "very high" inflations 90 percent. In the discussion, an "episode" includes all those years when the rate of inflation increased without interruption, based on the highest annual inflation rate reached; this peak inflation rate is reported here in parentheses.

Low Inflation Countries

Countries with extended records of price stability provide a useful comparative backdrop for understanding those cases in which more serious inflationary pressures emerge. Malaysia, Thailand, Taiwan, and Venezuela have all maintained annual average inflation rates of less than 10 percent since 1960. These countries have not been immune from periods of accelerating inflation: Malaysia in 1974; Thailand in 1973-4 and 1980; Venezuela in 1979-80 and 1987; and Taiwan in 1960, 1973 and 1980. With the exception of the episode in 1960 in Taiwan, which was the result of increased government spending in connection with the Taiwan Straits crisis, and Venezuela's difficulties in the 1980s, these inflations were largely the result of external shocks, however, and cannot be attributed in any significant way to government policy.

The range of countries that fall into this category suggests that it is possible to sustain price stability within the context of different economic structures and development strategies. The low-inflation Asian economies are more open than their Latin American counterparts. This may have an important effect on macroeconomic policies, since relative openness creates export interests that are sensitive to relative price changes, though the contrast between Taiwan and Korea suggests interesting differences among the export-oriented East Asian NICs. On the other hand, though Venezuela is an oil exporter, it resembles the other Latin American countries in terms of its industrial strategy. It has a large state-owned enterprise sector devoted to secondary import-substitution in intermediate and capital goods and high levels of protection.

The political systems of the low-inflation countries also appear to be quite diverse. Venezuela is a two-party democracy. Malaysia has been democratic since independence, with the exception of a brief interlude of emergency rule. It has been governed continuously by a ruling coalition that integrates conservative parties from the three ethnic communities, but in which the dominant Malay party is primus inter pares. Until the mid-1970s, Thailand had a long history of military rule. A brief liberalization in 1973-74 was reversed by a military coup, but since 1978, the country has been engaged in a controlled process of political liberalization and democratization. Taiwan has had continuous single-party rule since 1945 under the Kuomintang, but began a far-reaching political liberalization in the mid-1980s.

Notwithstanding these apparent differences, these political systems exhibit certain commonalities. First, all possessed party structures or other institutional arrangements that limited the organizational and coalitional possibilities of popular sector groups, thus insulating politicians from distributive claims "from below." Second, these institutions exhibited continuity over a substantial period of time. Finally, and in part because of the level of insulation and stability, politicians were willing to delegate authority to key technocratic decision-makers who enjoyed organizational autonomy and a high degree of credibility.

Taiwan and Thailand achieved stable macroeconomic policy under authoritarian auspices. Taiwan experienced a hyperinflation in the late 1940s as a result of the expansive monetary policy used to finance the KMT's military efforts on the mainland. Under strong pressure from the United States and rapidly declining reserves, the government instituted an innovative currency and financial reform that raised real interest rates for savers. Drawing a close connection between the hyperinflation and the political disaster on the mainland, Taiwanese monetary authorities have been vested with substantial authority and committed themselves to gold standard rules with a fixed exchange rate. The head of the Central Bank has usually been a person of high political stature, both fiscal and monetary policy have been tightly controlled by technocrats, and the scope for independent organization by interest-groups or parties has been, until recently, severely limited.

From the outside, Thailand appears to provide a sharp contrast to Taiwan. The country has a long history of coups and military plots. Urban political mobilization increased during the political liberalization of 1973-74, and in the 1980s, and the party system has always been quite fragmented. On closer examination, however, these differences are more apparent than real. Unions have, until recently, remained politically weak and parties have not divided sharply in ideological terms. Even during democratic interludes, the legislature has not been a significant locus of economic policy initiatives. All of the parties maintained their links to the key military and bureaucratic factions which exercised tight control over macroeconomic decision-making and along with monarchy provided the political system with a high degree of continuity.

Venezuela and Malaysia are important cases, since they demonstrate that similar outcomes are possible under democratic as well as authoritarian auspices. In Venezuela, oil income has no doubt played an important role in mitigating social conflict. Nonetheless, economic decision-making has also been insulated from popular sector pressures by the electoral dominance of two nationally-organized, vertically-integrated, multi-class parties, the Accion

Democratica (AD) and the Comite de Organizacion Politica Electoral Independiente (COPEI). De facto, the parties have established a collaborative relationship and limited the space for independent popular sector or leftist forces to operate. Labor's relationship with the parties has been institutionalized, but it has not translated directly into influence since each party also has substantial support from business groups and competes for roughly the same cross-class constituency.

These structures have not wholly immunized Venezuela against either inflation or other macroeconomic imbalances. The alternation of parties in office has led to important policy shifts. The administration of Carlos Andres Perez (1973-78) initially adopted a populist stance. This was shortly toned down, but the government did initiate a major expansion of public employment and investment in the state-owned enterprise sector, exploiting Venezuela's status as an oil exporter to borrow heavily on the Euromarkets. An overvalued exchange rate dampened pressure on prices over the 1970s. By 1979, however, an increase in inflation and perceptions of economic mismanagement contributed to a COPEI victory at the polls, followed quickly by a stabilization plan.

Precisely because of fears of inflation, the COPEI government persisted in supporting the overvalued bolivar; this only encouraged capital flight and further pressure on the currency. Venezuela's debt crisis broke in February 1983. The core of the adjustment program was a large devaluation, coupled with the initiation of a multiple exchange rate system designed to insulate the real sector from the effects of speculative capital movements. The government also took drastic action, however. The devaluation and fiscal squeeze no doubt contributed to COPEI's electoral defeat later that year. By now, however, the rival AD leaders also accepted the importance of reversing inflationary expectations and both the Lusinchi (1984-1988) and the Andres-Perez (1988-) governments launched comprehensive stabilization plans on coming to office.

These were seriously complicated under Lusinchi by the collapse of oil prices and under Andres-Perez by widespread riots against adjustment measures in 1989, and it remains uncertain whether Venezuela has finally returned to its low-inflation equilibrium. Nonetheless, it is clear that the two-party system has facilitated the imposition of stabilization programs in a democratic context.

Malaysia also demonstrates the importance of institutional arrangements for managing group conflicts, though the salient cleavages are different. Prior to the general election of 1969, serious violence erupted between the Chinese and Malay communities. Following a brief suspension of democratic rule, the new government of Tun Razak moved to construct a "grand coalition" that would integrate conservative leaders of the Chinese and Indian communities, while maintaining and institutionalizing Malay dominance of the political system. Policies designed to assist the Malays ('bumiputra'), including an expansion of the state-owned enterprise sector, contributed to the inflation of the early 1970s. High domestic savings rates and lucrative trade taxes have made it possible to finance large fiscal deficits in a non-inflationary way, however. These structural features of the Malaysian economy have contributed to the low-inflation outcome. But the political insulation and conservative orientation of the Malaysian monetary authorities, a legacy of the British currency board, has no doubt contributed. This in turn, has been reinforced by the ability of the Alliance party to shield macroeconomic policy from political contention.

Mixed Records: The Moderate Inflation Countries

Countries with mixed records are those which have experienced severe episodes of inflation for some period or recurrent problems of moderate inflation over a longer time period. One striking difference between this group and the low inflation countries is the shift in the relative importance of external and domestic sources of inflation. Many of the episodes in the moderate inflation countries overlapped with the two oil shocks, and Peru, Mexico, Turkey, and the Philippines faced severe budgetary problems as a result of the withdrawal of external financing. Yet domestic policy stance appears to have seriously aggravated the effects of external shocks.

The political characteristics of these countries differ predictably from the low inflation cases. Governments are more vulnerable to electoral constraints and more inclined toward developmentalist or redistributive orientations. There are also more episodes in which polarized or fragmented party systems have eroded the insulation of decision-makers. Nevertheless, it is noteworthy that no single factor was present in more than half of the inflation episodes delineated, and only rarely did any two of the three political factors operate together during the same episode.

Although distributive politics appears to play a greater role in these cases than in the low inflation countries, it is useful to examine how these pressures operated from country to country. Three subpatterns can be distinguished. In Indonesia, Jamaica, Turkey, and Peru, independent, well-organized political groups were temporarily mobilized in settings of party polarization and governments with strong redistributive orientations. In Korea and the Philippines, the legitimacy of incumbent governments has periodically been challenged, but opposition forces have remained weakly organized or vulnerable to repression. Mexico, Costa Rica and Colombia constitute anomalies, since the general security of officeholders, their relatively conservative political orientation and the party system seem otherwise conducive to stable macroeconomic policy. The effort of incumbent governments to adjust to new political demands has been one factor undermining stability, yet these systems also show surprising institutional capabilities that partially vindicate the institutional argument.

Indonesia, Jamaica, Turkey and Peru. The Indonesian inflation is a particularly clear case of radicalization and polarization of the political system giving rise to conflicting demands on the government and the loss of bureaucratic autonomy. The initiation of "Guided Democracy" in 1959 reduced the influence of western-oriented elites and established an uneasy troika between the radical nationalist Sukarno, the Army, and the Communist Party. The proximate cause of the inflation was fiscal deficits financed by unlimited money creation by the central bank; the real causes reside in efforts to placate the demands of polarized groups in a weakly institutionalized system. A grandiose 8 year plan announced in 1961 contained a variety of expensive projects for which there was little available money. The Planning Council degenerated into a purely political entity. The entry of the army into the government resulted in parasitic behavior that continued to pose challenges into the 1980s. Technocrats attempted a stabilization program in 1963, but the bureaucracy, army, Communists and Sukarno's policy of military "confrontasi" with Malaysia derailed the program. In 1965, the country slipped into hyperinflation.

Stabilization came only after Suharto's assumption of power. The island-wide massacre of the PKI leadership and cadre by the army and its mobilized Muslim and anti-Chinese supporters freed Suharto from any pressure on his left. Unions and business groups were weak, and in any case supported some easing of prices, as did the civil service and export interests ravaged by Sukarno's inflationary policies. The turning point came in 1966, when Suharto's ear was captured by a group of western-trained economists known later as the Berkeley mafia. An interesting feature of the stabilization was the passage of a constitutional provision that the budget be "balanced," in the sense that expenditures could not exceed revenues plus counterpart funds generated by the aid program. This limited the crucial mechanism that had operated before; unlimited central bank emissions. Though there are some subsequent pressures on the budget from the large state-owned enterprise sector, Indonesia's subsequent bouts with inflation stem largely from the inflow of foreign assets associated with oil, and every effort is made to manage them quickly. After 1970, Indonesia resembles the authoritarian low-inflation countries: a stable, single-party government with a low level of independent group mobilization and insulated economic bureaucracy.

In the mid-1970s inflationary pressures in Jamaica, Turkey, and Peru could also be traced to polarized social conflicts in which governments with strong redistributive objectives played a role. In this, they resembled the four high inflation countries, with the notable difference that these political characteristics were a departure from previous history. In the episodes initiating these inflationary cycles in the early 1970s, independent popular-sector groups were relatively weak and the primary impetus for inflation came from the developmental goals of the governments themselves. Over the course of the decade, however, growing political mobilization, polarization, and the redistributive conflicts spawned by inflation itself made it increasingly difficult for these countries to stabilize.

In Jamaica, Manley's attempt at a socialist experiment transformed a party system not previously marked by sharp ideological cleavages into a highly polarized one. Elections became the opportunity for violent clashes among partisans who were largely outside the control of political elites. In Peru, popular sector groups mobilized from above by the populist military Velasco government had very little autonomy or independence. By the late 1970s, however, Velasco's successors had to contend not only with the inflationary legacy of the ambitious redistributive and developmentalist policies of the populist phase of military rule, but also the increasingly independent and left-oriented political movements that period had spawned.

Turkey also demonstrates the way institutional structures can produce perverse incentives and intensify problems of collective action. In the mid-1970s, an ambitious program of investment in state-owned enterprises was sustained with foreign borrowing despite the first oil shock. Though the electorate continued to show overwhelming loyalty to the two major parties, extremist political forces on both the left and the right placed increasing strains on the center. In a classic case of the political fragmentation that can occur under proportional representation, governing coalitions proved difficult tc form, and were hostage to the demands of small anti-system parties. In this setting, it proved extremely difficult to cut government expenditure or adjust to the withdrawal of foreign lending. A stabilization program was announced under democratic auspices in 1980, but the government was quickly deadlocked over political issues and was ousted by the military in September of that year.

Korea and the Philippines. In these two countries, governments were more conservative than in Jamaica, Turkey, and Peru, and popular sector groups were less well organized and subject to outright repression. In both countries, however, governments have faced recurrent problems of legitimation, and used macroeconomic policy to cope with electoral and non-electoral challenges. While relatively low-inflation countries, the strategic use of macroeconomic policy and politically-motivated delays in stabilization help explain a pattern of recurrent, if moderate, inflation.

Korea shows evidence of a political business cycle. Large expansions of the money supply coincide with the election of 1963 and the 1969 referendum on a constitutional amendment that allowed Park Chung Hee to run for a third term. In 1973, in response to protest over the initiation of the authoritarian Yushin constitution, Park pursued a number of policies such as preferential tax breaks for the working class that were designed to reduce the likelihood that the opposition would exploit the grievances of labor and the urban poor. During the second half of the decade, the government's commitment to industrial deepening led to rapid growth of domestic credit and external debt and strong pressure on labor markets. The inflationary episode of 1979 is partially attributable to these policies. Unlike most developing countries, a commitment to stabilization emerged prior to the second oil shock, but it was not fully implemented due to the political instability both before and after the assassination of Park in October 1979. Not until the consolidation of power under Gen. Chun Doo Hwan were consistent stabilization measures adopted.

Notwithstanding the numerous differences between Korea and the Philippines, there are also some interesting similarities. The upsurge of inflation in 1971 was directly linked to expansionary policies undertaken in support of Marcos' unprecedented bid for a second term as president. Subsequent episodes of inflation were mainly the result of the oil shocks, but as in a number of other countries, Marcos borrowed heavily over the 1970s to finance an ambitious expansion of the public sector. With many projects tied to cronies of the Marcoses, the government proved slow in adjusting to the adverse trends in its terms of trade. The surge of inflation in 1984 followed the loss of confidence on the part of external creditors after the assassination of Benigno Aquino in 1983 and the upsurge of protest that followed. One reasons for the rapid expansion of the money supply in early 1984 was to deflect attention from the opposition in anticipation of a critical election in May 1984.

Mexico, Costa Rica, and Colombia. These three countries would appear to pose a challenge to an institutionalist explanation of macroeconomic policy. All experienced serious episodes of inflation during the 1970s and 1980s in spite of the fact that, as in Venezuela, multi-class parties have dominated the electoral arena and government over a long period of time. This feature of the political system did place strong limits on distributive conflicts in all three countries, and enabled governments in the 1950s and 1960s to maintain considerable price stability.

In common with a number of other developing countries, however, the commodity and borrowing booms of the 1970s allowed strongly developmentalist administrations to promote the growth of large state-owned enterprise sectors with extensive links to powerful import-substituting business interests; this was particularly true in Mexico and Costa Rica. Expanding fiscal commitments left these economies particularly vulnerable to sharp declines in commodity prices and to the freeze on commercial bank lending of the early 1980s. The severity of the inflation in Costa Rica can be traced almost entirely to this factor. The conservative but deeply divided Carazo administration delayed in responding to the collapse of coffee prices and the first oil price shock. Under a new government, stabilization and structural adjustment measures were rapidly put in place, and Costa Rica resumed its previous low-inflation trajectory.

In Mexico and Colombia, however, the situation was complicated by political challenges from increasingly militant popular-sector groups operating outside the traditional party structure. Colombia's traditional two-party system resembles Venezuela's in its cross-class electoral appeal, and has provided the basis for policy-makers to pursue cautious policies. In 1968, constitutional reforms backed by the leaders of the two dominant parties, the Liberals and Conservatives, virtually eliminated congressional control over fiscal and monetary policy. In the presidential elections of 1970, however, the joint candidate of the traditional parties was almost defeated by the ex-dictator, Gustavo Rojas-Panilla, who campaigned on a strongly redistributionist platform. Organized labor, which generally operated outside the framework of the party system, became more militant. By the mid-1970s, the strong boom in coffee exports added to the problem of maintaining price stability, as authorities proved unable to sterilize the inflows of foreign assets or to resist pressure for increased expenditures.

Financial authorities managed these pressures through a combination of concessions and cautious macroeconomic policy. On the one hand, union demands were deflected through an implicit system of wage and salary indexation. On the other hand, the government relied on backing from influential financial and export groups within both parties to sustain high real interest rates and to allow growers to retain much of the coffee surplus. Exporters also gained from a crawling peg exchange rate, though adjustments were not always adequately fast. In conjunction, these policies allowed Colombia to maintain a moderate, but relatively constant, level of inflation.

Until the early 1970s, Mexico fit squarely within the low-inflation category. Under Luis Echeverria's mildly populist administration (1970-1976), the insulation of key financial technocrats in the Central Bank and Ministry of Finance eroded. In the face of business resistance, the government proved unable to initiate the tax reforms required to finance ambitious distributive programs and industrialization plans. Attempts to appease the conflicting pressures on government coming from business and labor through growth had inflationary consequences and in 1976 forced the first adjustment of the exchange rate since 1954. The oil boom of the late-1970s coincided with a liberalization of Mexican politics, including the formation of new unions and political parties. While not able to directly influence policy or to challenge the PRI's dominance, the ruling party's concerns about its electoral fortunes contributed to a particularly heavy borrowing against oil revenues and the failure to make adjustments in fiscal policy. By the time the more orthodox de la Madrid administration came to office, ballooning service costs on government debt made fiscal deficits difficult to control and tended to undermine very harsh wage and credit policies.

Mexico's inflation during the 1980s was much higher than in Colombia and Costa Rica, but it eventually proved more manageable than in the polarized political systems of southern South America. The de la Madrid administration deployed the control mechanisms of the dominant party to implement a substantial change in the overall direction of macroeconomic policy after 1982. Although there is debate over the consistency with which the government maintained fiscal discipline, non-interest expenditures were slashed and credit remained very tight. Using its extensive leverage over the official labor organizations, the government maintained strict control over nominal wage increases throughout the administration. Overall austerity was relaxed somewhat in 1987 in anticipation of the presidential elections of 1988, but when inflation began to accelerate at the beginning of the campaign, the government responded with a new austerity package that combined tough fiscal retrenchment with wage and price controls. Despite Mexico's very high inflation, its efforts at stabilization since 1983 and its willingness to pursue an orthodox policy line toward creditors reflect a continuing ability to absorb costs that would have been extremely difficult in other national settings.

The High Inflation Countries: Argentina, Brazil, Chile and Uruguay

Table 2 suggests that Argentina, Brazil, Uruguay and Chile prior to the mid-1970s have had inflation histories that differ quite substantially from the other countries in the sample. These countries show both high average inflation rates over the long-run and a high degree of volatility in prices. Among them, these four countries account for twelve of the twenty-one episodes of high inflation and nine of the fourteen very high inflation episodes.

External shocks are clearly one component of the story, particularly in the 1980s. The oil shocks contributed to the acceleration of Brazilian inflation in the mid-1970s and after 1981, and the interruption of external lending figured significantly in four episodes: Brazil 1981-87; Argentina 1982-85 and 1987; and Uruguay 1983-86. The swift end of easy access to the

Euromarkets constituted a double shock: it cut off a major source of government financing; and effectively forced governments to assume responsibility not only for public debt but for private sector liabilities as well. The sheer size and speed of the required adjustment foreclosed the possibility of smooth adjustment through increased revenues and domestic borrowing. Governments had little choice but to resort to seignorage financing.[18]

The need to generate substantial current account surpluses through large devaluations also contributed to inflation. While all debtors faced this problem, it was particularly severe where the government attempted to use the exchange rate as a nominal anchor through the policy of a fixed exchange rate or pre-announced devaluations. These policies were adopted under military governments in Chile, Argentina and Uruguay as components of ultra-conservative political projects designed to permanently reduce the influence of leftist and labor groups.[19] With liberalized trade and financial flows disciplining the domestic labor market, an overvalued exchange rate, it was argued, could be used to bring down domestic prices and lower inflationary expectations. In all three cases, however, the exchange rate became increasingly overvalued, as a result of expansionary fiscal policies in Argentina, as a result of the inability to contain wage pressures in Chile. Over time, it became impossible for governments to prevent growing speculation against the monetary authorities. These experiments in conservative economics ended by the early 1980s with capital flight, major external accounts crisis and in Argentina, near hyper-inflation.[20]

Though external shocks were important in contributing to the high inflations of the 1980s, Argentina, Brazil, Uruguay, and Chile before Pinochet had histories of high inflation that dated to the 1950s. Most of the inflation episodes in these countries appear unrelated to external shocks. These long-standing patterns of inflation do have political correlates, however, generally combining two or three of the political mechanisms we would expect to erode stable macroeconomic management: strong labor movements linked to polarized political parties; severe tenure insecurities; and a propensity for governments with strongly redistributive orientations.

The most persistent feature of these countries prior to the 1980s was the extent to which well-organized labor movements were linked to highly polarized political parties. In Argentina, Chile and Brazil, in contrast to the other Latin American countries we have discussed, anti-oligarchical parties of the center and left recurrently sought the support of urban workers and small manufacturers by appeal to class and sectoral interests. Uruguay is a partial exception, since the Colorado and Blanco parties traditionally engaged in cross-class appeals. During the inflationary crises of the 1960s and early 1970s, however, both parties had become internally polarized along left-right lines, and a third political coalition, the left of center Frente Amplio (Broad Front) had gained a strong base of support in Montevideo and in the labor movement. During the 1980s, it might be noted, the reduction of party polarization in both Uruguay and Chile coincided with the containment of inflationary pressures, although it is still unclear how long this will last.

Details of the struggles within these countries and the mechanisms through which they generated inflation differ somewhat from case to case. Chile under Allende provides the clearest example of popular-sector mobilization by a leftist party resulting in deepening social and political polarization and severe macroeconomic problems. Brazil experienced a somewhat similar episode in 1964 under Goulart. In Argentina, the independent role of unions was highly circumscribed during the first Peronist regime. Inflationary impulses came from the government's populist political and economic objectives rather than from independently organized labor. Inflationary episodes that occurred after Peron's ouster in 1955, however, reflected increasingly polarized class and sectoral conflict, as conservative coalitions of military, industrial and agrarian elites confronted militant unions linked to the Peronist opposition.

In both Argentina and Uruguay, where the principal exports were also wage goods, inflationary conflicts between popular-sector groups and their opponents were frequently triggered by devaluations. These would first shift the internal terms of trade toward agro-export groups in the tradables sector, then generate strong popular sector pressures for compensating wage and price increases. Somewhat similar sectoral pressures on the budget were visible in Brazil during the inflationary surges of 1956, 1959, and 1964. Governments that had sought to implement fiscal adjustments to counter declines in coffee prices were caught between the demands of the growers, the demands of industrialists for price supports and credit, and growing wage demands from an increasingly radicalized labor movement.

Popular sector groups have generally emerged as losers in such struggles, as temporary gains in real income are quickly eroded by inflation. Nonetheless, in a polarized political setting where contending forces represent sharply contending preferences, labor may face few good choices. For groups which are economically weak and vulnerable to repression, stabilization also implies disproportionately heavy costs, with few assurances of future benefits. Thus, in the types of cycles described above, the most prudent course for labor is to press for a defense of real wages when political conditions permit, <u>even if it is clear that inflation will increase and that real gains will be eroded by the counter-claims of other, more powerful groups.</u> Such situations constitute classic prisoner's dilemmas. Moreover, contrary to the so-called "folk theorem" that iterated play can bring cooperation by lengthening time horizons, iteration may only reinforce the reluctance to compromise.

Polarized politics and a mobilized left will affect the time horizons of politicians and fiscal policy independently of electoral constraints, but tenure insecurities have also been particularly intense in the high inflation countries. In ten of the fourteen very high inflation episodes, for example, sharply contested elections or broader challenges to the security of tenure constituted major constraints on economic decision-making. In two cases--Argentina in 1975-76 and Brazil 1962-64--democratic governments faced explicit pressure from militaries, and in Argentina and Brazil in the 1980s, new democratic governments faced difficult problems of political consolidation.

Chile provides the clearest case of a well-defined electoral cycle. In four of the Chilean episodes (1953-55; 1958-59; 1962-64, and 1968-70), surges of inflation at the end of a presidential term could be traced to expansionary programs instituted as each new president took office. Since these programs were launched in recessionary conditions, there would initially be some success in reigniting growth and slowing inflation. By the second half of each administration, however, the expansion would begin to strain the limits of existing capacity. In the context of upcoming elections, incumbent governments were unable to resist inflationary demands from organized labor and business interests. Each president would thus leave office in the context of stagflation, and the cycle would begin again under his successor. Two of these cycles involved explicitly populist governments, and in the last two episodes, the party system became increasingly polarized as well, with the centrist Radical party declining in importance and the left and right poles gaining in strength. In Uruguay, the inflation episodes of 1968 and 1973 were also preceded by large increases in public sector wages and fiscal deficits implemented by incumbent governments during the electoral campaigns of 1967 and 1971.

As we have already seen in countries with lower inflation, authoritarian governments have also faced political pressures that have affected time horizons, including elections and efforts to negotiate and control transitions to democratic governance. In the face of mounting protest, authoritarian regimes pursued expansionist policies or delayed stabilizations in Brazil in the late 1970s, Uruguay in the early 1980s, and in Argentina in both 1971-73 and 1981-83. In Uruguay and Argentina, political liberalization undermined the ability of the government to use exchange rate policy as a nominal anchor. As business and labor increased their demands for a relaxation of credit and wage policies, the exchange rate in both countries became increasingly overvalued, contributing ultimately to both countries' economic difficulties.

Finally, although the military governments of the 1970s were highly conservative, it should not be surprising that the dynamics of polarized party conflict described above have intermittently led to the emergence of strongly redistributive governments that have used macroeconomic instruments to engineer increases in the real incomes of urban groups. Notwithstanding important differences in their long-term goals, the major examples would include the Peronist governments in Argentina, Goulart and Sarney in Brazil, and Ibanez and Allende in Chile. The Garcia government, elected in an increasingly polarized context in Peru, represents an additional example. While inflationary episodes have occurred in these countries under all types of governments, including nominally conservative ones, these radical-redistributive governments have tended to push inflation peaks to new heights within their respective countries.

As Sachs and Dornbusch and Edwards have argued, there is a remarkable similarity in the economic programs initiated by these "populist" governments.[21] The objective of increasing the real income to urban groups is usually coupled with a "developmentalist" program of structural reform designed to relieve productive bottlenecks. In its radical-transformative variant, populism aims at a more basic redistribution of assets through land reform or nationalization.

New populist governments uniformly reject the claim that deficit financing is inflationary, arguing that the mobilization of unused spare capacity, declining costs, and price controls can be used both to stimulate growth and lower inflation. They typically combine support for real wage increases with rapid monetary and fiscal expansion which, under a fixed exchange rate, also raises urban wages and industrial profits at the expense of the tradable goods sector. During the initial phases, policy makers enjoy a honeymoon, as their prescriptions appear to be vindicated. Reserves inherited from the previous government provided a crucial cushion for meeting import demand. Output, real wages and employment all improve, while direct controls are deployed to manage inflationary pressures.

Within two or three years, however, domestic demand generates a foreign exchange constraint, and the deterioration of existing reserves places increasing pressure on the exchange rate. Devaluation is initially rejected, both because of its inflationary and distributional consequences. Controls on trade and capital movements proliferate, the budget deficit widens, and reserves shrink. In the third phase, the disparity between official and black market exchange rates and general lack of confidence leads to capital flight and large devaluations. Inflation soars, and stabilization finally becomes a political priority.

III. How Inflations End: The Political Economy of Stabilization

In the previous section, we focused on some long-run political correlates of inflation; here we turn to the circumstances under which inflations have been brought under control. We are concerned with three outcomes: the timing of stabilization efforts and whether adjustment was delayed; the nature of the stabilization package, particularly the mix between "orthodox" and "heterodox" adjustment measures; and the success in sustaining stabilization efforts.

We are particularly interested in understanding the relative capacity of authoritarian and democratic governments in managing inflation. Is a suppression of distributive conflicts a necessary component of "successful" stabilization? Our working hypothesis is that this will depend on the level of inflation and the political dynamics that underlie it. Higher inflations require more severe fiscal and monetary policies, in part because government reputation is likely to have been eroded and inflationary expectations deeply engrained. We expect that democratic governments will have greater difficulty stabilizing higher inflations, particularly where polarized political struggles have contributed to price instability over a number of recurring stop-go cycles.

To explore these issues, we look more closely at the outcomes of the inflation episodes outlined in the previous section. Tables 3 through 5 array these episodes in terms of the level of inflation, the political circumstances at the time of the episode, the type of political regime that attempted stabilization, and the outcome. The standard of "success" is whether inflation is brought below the inflation threshold for each level of inflation for three years. Thus, moderate inflations are successfully stabilized if the government brings inflation below 15 percent for three years following its peak level, high inflations if the government achieves inflation rates below 30 percent for three years, and very high inflations if the government reduces inflation below 90 percent for three years. Such a standard of success is quite generous, since it sets tolerant standards for higher inflations, deals only with the medium-term, and does not incorporate information about growth rates and employment.

Though the number of cases is too few to draw firm conclusions, three important points emerge from Tables 3, 4, and 5. First, even by these quite generous definitions of "success," inflations were increasingly difficult to control as they moved toward higher levels. About two-thirds of the moderate inflations were reduced below the fifteen percent threshold, but less than half of the high and very high inflations were brought down for three years.

The second point is that type of political regime has tended to make more of a difference at higher levels of inflation. At moderate levels, authoritarian and democratic regimes manage successful reductions in inflation with about the same frequency. At high levels of inflation, however, only three of the ten democratic governments were able to reduce inflation and these were at the low end of the high inflation range, between 30 and 40 percent. In the very high inflation category, three of seven democratic regimes managed to stabilize, but these were at the low end of the very high inflation range. Moreover, in two of these three cases, there were significant limitations placed on civil liberties.

Finally, Table 6 contrasts the performance of those political systems that are polarized or fragmented (coded '3') with non-polarized democratic and authoritarian regimes. Only about 40 percent of the inflations in polarized systems were brought down for three years, as compared to 70 percent of inflations in political systems where conflict was mediated by catch-all parties or suppressed. In these non-polarized situations, democracies did as well as authoritarian regimes; indeed, democracies actually have a lower failure rate. In polarized situations, however, 10 of 14 authoritarian regimes achieved some success while among the 14 constitutional governments, only four managed to lower inflation over the medium-run. Again, however, in these four cases, nominally democratic governments operated under significant limits imposed by the military on the range of political activity.

The strong association between high levels of polarization and high levels of inflation makes it difficult to separate their effects. A closer examination of each category of inflation provides some basis for understanding the political dynamics of inflation, as well as the timing and content of stabilization packages.

Table 3
Political Correlates of Stabilization:
Moderate Inflation Cases

	Inflation reduced below 15 percent for at least 3 years				Inflation persists		
	Elect	Orient	Polar		Elect	Orient	Polar
Democratic							
Colombia 1966	1	2	2	Brazil 1952-56	1	4	3
Venezuela 1979-81	0	2	2	Jamaica 1973-75	0	4	3
Malaysia 1974	1	3	2	Turkey 1971-76	1	3	3
Thailand 1980	0	2	2				
Authoritarian							
Indonesia 1978-79	0	1	1	Phil. 1970-71	0	2	3
Korea 1963-64	1	1	1	1980	0	1	1
1970	1	1	1	Peru 1973-75	0	3	1
1974-75	0	1	1	Mexico 1974-77	1	3	2
1979-80	1	1	3				
Taiwan 1960	0	1	1				
1980	0	1	1				
Thailand 1973-74	1	2	3				
Peru 1965-68	0	3	3				

(Key: Elections: 1, national election for chief executive during the episode or within following year; 0, no election.

Government orientation during majority of the episode. 1. Conservative, anti-labor, an left government; 2. Centrist government or coalition including both center-right and center-left components; 3. social-democratic or center-left government; 4. socialist or populist government.

Polarization: 1. Exclusive one-party systems; 2. Inclusive or corporatist one-party systems or two-party systems with broad, catch-all parties; 3. polarized or fragmented party systems.

Table 4
Political Correlates of Stabilization
High Inflation Episodes

Inflation reduced below 30 percent for at least 3 years				Inflation persists			
	Elect	Orient	Polar		Elect	Orient	Polar
Democratic							
Colombia 1963	0	2	2	Brazil 1959	1	3	3
Costa Rica 1973-75	0	3	2	Chile 1953-55	0	4	3
Jamaica 1978-80	0	4	2	1958-59	1	4	3
				1962-64	1	2	3
				1968-69	1	3	3
				Colombia 1973-82	0	3	2
				Peru 1976-81	1	2	3
				Uruguay 1959-60	0	1	2
Authoritarian							
Argentina 1949-52	0	1	1	Argentina 1971-73/	1	2	3
1962-67	1	2	3	Brazil 1974-79	0	2	1
Indonesia 1972-73	0	1	1	Uruguay 1983-86	1	1	1
Philippines 1973-74	0	1	1				
1984	0	1	3				
Taiwan 1973-74	0	1	1				

(Key: see Table 3)

Table 5
Political Correlates of Stabilization
Very High Inflations

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	Inflation reduced below 90 percent for at least 3 years			Inflation persists			
	Elect	Orient	Polar		Eiect	Orient	Polar
Democratic							
Costa Rica 1981-83	1	3	2	Argentina 1982-5/1		1	3
Argentina 1958-59	1	2	3	1987	1	3	3
Uruguay 1964-68	1	1	3	Brazil 1981-87			
				Peru 1983-85	1	4	3
Authoritarian							
Brazil 1962-64	0	4	3	Argentina 1975-77/0		3	3
Chile 1972-74	1	4	3	Uruguay 1972-75	1	1	3
Mexico 1983-87							
Indonesia 1962-66	0	4	3				
Turkey 1977-80	1	2	3				

(Key: See Table 3)

Table 6
Polarization, Political Regimes, and Stabilization

	Democratic		Authoritarian	
	Successful Stabilization	Inflation Persists	Successful Stabilization	Inflation Persists
Non-polarized or suppressed				
	Colombia 1966	Colombia 1963	Argentina 1952	Brazil 1979
	Colombia 1977	Uruguay 1959	Indonesia 1973	Mexico 1977
	Costa Rica 1974		Indonesia 1978	Peru 1975
	Costa Rica 1982		Korea 1970	Uruguay 1983
	Venezuela 1980		Korea 1974	Philippines 1980
	Malaysia 1974		Taiwan 1960	
			Taiwan 1974	
			Taiwan 1980	
Polarized				
	Argentina 1959	Argentina 1985	Argentina 1966	Argentina 1973
	Uruguay 1968	Brazil 1956	Brazil 1964	Argentina 1977
	Korea 1964	Chile 1955	Chile 1974	Uruguay 1973
	Thailand 1973	Chile 1959	Indonesia 1966	Philippines 1971
		Chile 1962	Peru 1968	
		Chile 1968	Korea 1980	
		Jamaica 1973	Philippines 1984	
		Peru 1981	Turkey 1980	
		Peru 1985		
		Turkey 1971		

(Key: See text for definitions of successful stabilization and persistent inflation. Episodes identified by peak inflation year.)

Stabilizing Moderate Inflations

We begin, as we did in the previous section, with an analysis of the moderate inflation episodes. Arguably, the same political factors that limited inflationary pressures in the first place also allowed for a quick return to price stability. Most of these cases, as we have seen, were in countries where broader political pressures were muted in some form and where conservative economic decision-makers enjoyed substantial autonomy. Most of the successful stabilizations in this category came in countries that had long-term records of low or controlled inflation, and in which governments enjoyed a high degree of credibility.

It could be countered that "stabilization" in these cases was frequently not required. Changes in the external environment, particularly the stabilization of oil prices, was a crucial factor in five of the episodes in which inflation fell and was sustained at a lower level. This was true in Korea 1973-74, Malaysia 1974, Taiwan 1980 and Thailand in 1973-74 and 1980; these constitute nearly half of the "successful" cases. In most of these successful cases, however, both democratic and authoritarian governments moved quickly to counter external disturbances with orthodox demand-management responses, although usually not without substantial debate over the degree and timing of the policy adjustments required. This stands in sharp contrast to the delayed response to external shocks in a number of the higher inflation cases where more extensive political constraints operated.

The episodes in Korea and Venezuela warrant more detailed comment. Park Chung Hee, because he faced greater potential threats from an urban political opposition, adopted a more heterodox adjustment strategy than the other success cases. The government responded aggressively to the oil crisis by borrowing heavily to maintain investment in export industries and a high level of growth. This gamble paid off when growth resumed in Korea's major export markets. Inflationary pressures were contained by the stabilization of oil prices, price controls, and a generally conservative fiscal policy, though the government's aggressive industrial strategy contributed to the re-emergence of inflation in 1978.

In Venezuela, by contrast, orthodox stabilization measures can be considered "successful" only in very narrow terms. The strong, multi-class parties did work to discourage challenges to the stabilization program imposed in the late 1970s, and tight monetary and fiscal policy contributed to bringing inflation down in the early 1980s. This came at the cost of a severe recession, however, as well as sharp cuts in capital expenditure and investment. As in many other Latin American countries, the government also maintained an overvalued currency, which left it extremely vulnerable to the debt shock and forced adjustments of 1983.

Although lower levels of inflation were generally easier to control than higher ones, stabilization of "moderate" inflations did frequently pose political difficulties for governments. Though most of the governments in this group were able to return quickly to price stability, seven governments were not able to do so: Brazil 1952-56; Turkey 1971-76; the Philippines 1970-71 and 1980; Jamaica 1973-4; Peru 1973-5; and Mexico 1974-77. As expected, these governments faced greater tenure or electoral insecurities, political polarization or fragmentation than the success cases. Governments in all three of the unsuccessful democracies confronted party systems or political movements that were dividing along distributional lines, as did Peru after

1975 and the Philippines prior to martial law in the early 1970s. Mexico experienced no basic change in its political structure, but it did begin a political liberalization that made the ruling party more sensitive to electoral constraints.

As in Korea, governments in these societies responded to balance of payments problems by seeking increased external financing and stepping up investment programs to counter recession. In at least one case--Brazil in the mid-1950s--this strategy paid off in high growth rates. Unlike Korea, however, these governments could not count on foreign exchange earnings from a diversified export sector, and did not have the political capacity to control fiscal deficits. Both problems left them highly vulnerable to more serious inflationary crises in subsequent years.

Stabilizing High Inflations

As Table 4 shows, the success in taming high inflations is more limited than efforts to stabilize moderate ones. Eight of the nineteen episodes (42 percent) were followed by a rapid recurrence of the inflationary cycle. Four of these occurred in Chile, but as we have seen, long-term inflationary problems also plagued Argentina, Uruguay, and Brazil. Popular-sector groups played major or supplementary roles in all but one of these eight cases (Uruguay, 1983-87).

Successful efforts to reduce inflation tended to occur at the lower end of the 30-90 percent range, and in several instances was attributable as much to changes in the external environment as adjustments in domestic policy. This was the case in the Philippines (1973-74) and Costa Rica (1973-75), which increased their borrowing in response to the first oil shock, and arguably in Jamaica in the early 1980s. To contain a pressing balance-of-payments crisis, the conservative Seaga government avoided conventional stabilization, relying instead on generous foreign assistance and an overvalued exchange rate. By 1984, however, inflationary pressures had re-emerged.

Effective, medium-term stabilizations were achieved in only two of the eight episodes in which price increases peaked at over 40 percent, Indonesia and the Philippines. In Indonesia, where the main cause of the inflation had been the monetization of oil surpluses, stabilization came under unusual conditions. Inflation was brought down in part through the adoption of more effective techniques of monetary management, but the financial difficulties of the over-extended state-owned oil enterprise, Pertamina, also forced the government to repay a portion of its external debt, effectively sterilizing the growth of foreign assets.

External constraints, particularly the unavailability of credit in the wake of the Aquino assassination and strong pressures from the IMF and banks, were important in forcing stabilization on the Philippines in mid-1984. Once the decision to stabilize was made--and it was delayed in anticipation of elections in May--the absence of a strong labor movement or of indexation contributed to the speed with which prices could be brought down. The program hit extremely hard at urban living standards, however, and the Marcos government was overthrown less than two years after launching the program.

With a few exceptions, such as Korea's supply-side adjustment strategy, stabilization in the moderate inflation cases generally centered on traditional instruments of demand management: fiscal, monetary, and wage policy. Because stabilizing higher levels of inflation entails higher political and economic risks, several governments turned to comparatively heterodox means of stabilizing prices in the high inflation episodes. The stabilization program launched by the Ongania government in Argentina (1966-70) is noteworthy in this regard, since it departed substantially from the conventional IMF recipes of the time. Devaluation, a reduction of fiscal deficits, and strict wage controls were instituted, but the government also took additional measures aimed at avoiding the recessionary effects that had accompanied earlier IMF programs. A large tax on traditional exports allowed the Treasury, rather than agro-exporters, to capture the gains from the devaluation. With fiscal problems eased by increased revenues, the government was in a position to maintain a moderate flow of credit to the private sector and to engage in a mildly expansionist program of public construction and subsidies to manufactured exports, supplementing these measures with controls on some key prices. Within six months, inflation had been reduced to single digits and growth had resumed, all without a major drop in real wages. In 1969 and 1970, however, the program was abandoned in the face of increasing pressure from landowners, small ISI firms, and Peronist-dominated unions that had been excluded from political power under the military.

A second heterodox alternative is to finesse the political costs of stabilization in the short-run by indexing prices and wages.[22] This was the route chosen by both Colombia and Brazil during the late 1960s. Minidevaluations were pioneered by the Colombian government to counter the tendency toward real appreciation that had contributed to payments disequilibria in earlier years. The minidevaluations contributed to mounting pressure from the organized labor movement, however. In response the Colombian government established an "implicit system" of wage and salary indexation. An extensive system of indexing allowed the Brazilian military regime to accomplish roughly similar objectives between 1968 and the mid-1970s.

For both the Brazilian and Colombian governments, indexing appeared to reduce the distributional conflicts that accompanied increasing inflation, and was thus a tool for depoliticizing industrial relations. In both cases, however, the success of this strategy ultimately rested on fiscal conservatism, which in turn was related to the underlying political context. Brazil's move to indexation was preceded by a very harsh orthodox stabilization program imposed by the military from 1964-1967 that involved a particularly severe compression of real wages. As the Brazilian military regime began to relax political controls during the second half of the 1970s, long-standing distributional pressures resurfaced. Government concessions and its own developmentalist objectives were reflected in growing fiscal and current account deficits and increasing inflation. Indexing also resulted in the price effects of adverse supply shocks being transmitted quickly throughout the economy, generating inertial spirals. Inflation doubled to about fifty percent in the wake of the first oil shock, and to 100 percent after the second, remaining at that level between 1980 and 1983 in spite of an exceptionally tight monetary policy imposed by the regime.

Stabilizing Very High Inflations

Stabilizing very high inflations poses a number of technical problems that are different from the stabilization of inflation at lower levels. These can only be outlined briefly here, but some exposition of these problems is necessary to understand the particular political problems at issue.[23] First, inertial forces are likely to operate quite independently of government intentions. As inflation increases, indexation becomes more pervasive. Once this system is in place, de-indexing poses classic collective action dilemmas; while all might be better off, the player who is "deindexed" first risks substantial real income losses.

As financial instruments are indexed, government debt and interest payments can grow at a rapid rate even if fiscal authorities prefer retrenchment. Inflation, lags in tax collection and in the adjustment of tax brackets can all result in a decline in the real value of tax revenue. This helps explain the rapid increase in government deficits in high inflation settings.

Expectations play a critical role in this inertial process. In setting prices and wages, firms and workers will take past inflation as a baseline prediction of future inflation. This reduces the scope of adjustment that can be achieved by traditional demand restraint measures alone. If prices are increasing at 200 percent annually, for example, and firms were able to hold nominal wage increases to 180 percent, this would represent a draconian cut in real wages, but would only have a marginal effect on inflation. Similarly, cutting profit margins is unlikely to have much influence on inflation.

These particular problems of high inflation explain why some sort of heterodox strategy of inflation management involving wage and price freezes is likely to be not only politically attractive, but economically necessary. Yet as the failed heterodox experiments in Peru, Argentina, and Brazil have made clear, heterodox experiments cannot work unless there are also adjustments in the monetary and fiscal fundamentals. This is true not only because of the economic effects of continued fiscal and monetary expansion, but because of the crucial role government policy will have on expectations; incredible adjustment programs will quickly be undermined by forward-looking economic agents.

It needs little elaboration to see that these "technical" difficulties pose political challenges of the first order and that the very high inflations are likely to raise the question of the relationship between regime type and stabilization.[24] The past record is not very comforting. The three democratic failures have all come in relatively new democracies: Peru, Argentina and Brazil. For these governments, all of which inherited high inflation from their military predecessors, heterodoxy appeared to have political as well as economic advantages. All three experimented with stabilization packages involving wage-price controls and currency reforms, but all proved unable to sustain the fiscal and monetary control required to make the heterodox component of the stabilization viable. Under Sarney in Brazil and Alan Garcia in Peru, wage and price controls were components of populist programs, and deployed as substitutes for, rather than complements to, more orthodox measures. Real wages were allowed to rise substantially, there was virtually no effort to limit subsidies or control spending. When pressure on prices ultimately forced the relaxation of controls, a new spiral of inflation began. Brazil experienced three such cycles between 1985 and 1989.

The Argentine attempt at heterodoxy, instituted in 1985 under much tighter foreign exchange conditions and a center-right government, placed greater emphasis on maintaining wage restraint and bringing fiscal deficits under control. These efforts weakened over the next several years in the face of strong electoral challenges from the Peronist opposition, strong resistance to tax reform, the continuing drain of debt servicing on fiscal resources, and more generally, a weakly institutionalized budget process. Menem's efforts at curbing the Argentine hyperinflation of May and June 1989 after assuming office in July appears to have followed a similar pattern. Sweeping programs were weakened by the inability to limit fiscal deficits.

Only in three instances did very high inflation come down under civilian governments, and in two of these three cases, Uruguay in the 1960s, and Argentina in 1959, these civilian regimes significantly curtailed civil liberties. Significant limitations on civil liberties was also evident in another "success" story not included in this sample, the stabilization of the Bolivian hyperinflation in 1985, when several hundred union leaders were arrested and the union movement virtually destroyed. This leaves the case of Costa Rica as the only fully democratic regime which managed to stabilize a very high inflation, and this came at the low end of the high-inflation range.

There are, however, important variations among the "successful" high inflation stabilizations in the degree of political continuity, the extent of political repression and the severity with which costs are imposed on the organized working class. These are related in predictable ways to the nature of the political institutions and the degree of polarization and social conflict which accompany the inflation episode.

At one extreme are stabilizations that remain broadly within the constitutional framework. In Uruguay in 1968, the death of moderate president Oscar Gestido lead to the succession of conservative vice-president Jorge Areco who used new constitutional powers to declare a state of seige and impose an austerity program. The program was characterized by a wage freeze, price controls, a fixed exchange rate, and very tight fiscal and monetary policies. Censorship was instituted and attempts made to repress unions. Prices came down, but confrontations with increasingly militant labor and left groups continued, and the stabilization package unravelled during the sharply contested election campaign of 1971. The Argentine stabilization of 1959 was more orthodox, relying on a large devaluation followed by strict wage controls and very tight monetary policy. The program was instituted after the military had forced Frondizi to install a finance minister of their choosing, and was sustained because the Peronist party remained illegal.

Mexico also exhibits continuity in its basic political structure, and has had substantial success in reducing inflation in a context which, while authoritarian, has not been harshly repressive. In 1988, the de la Madrid government brokered a "Solidarity Pact" after five years of reliance on traditional demand-management approaches. The pact, negotiated with business elites and "official" unions, provided for wage and price controls that were crucial ingredients in lowering the inflation over the next two years. This was possible because official unions were integrated into the party structure. Mexico is thus the one very high inflation case in which the government was able to gain voluntary compliance from at least some portions of the working class. Nevertheless, it is also the case that the pact was accompanied by the continuation of very tight wage and credit policies that could probably not have been sustained under more open and competitive political conditions.

The combination of a high degree of social polarization and conflict with high levels of inflation has been an important factor in authoritarian installations in a number of the cases in our sample. In these cases, the tasks of restructuring politics and the economy have usually been closely linked. Incoming military governments have sought not only to control inflation and restore private sector confidence, but to curtail the activities of labor and the left, which are held accountable for the economic deterioration. Once again, however, important distinctions can be drawn among these new authoritarian regimes as well.

Far-reaching changes in both the economy and polity followed the coup in Indonesia (1965-66). Unlike the Latin American cases, however, inflation in Indonesia was less directly the result of the competing demands of organized social groups, and thus the link between repression and economic strategy was less clear. The process of reform could be effective by changing procedures within the government itself. Following the advice of a cadre of economists known as the Berkeley mafia, and painfully aware of the extreme costs associated with Sukarno's inflationary course, Suharto institutionalized a budget process that provided checks on the ability of the central government to pursue expansionist fiscal policies. Though these constraints were somewhat relaxed by the oil boom of the 1970s, the government has nonetheless maintained a relatively tight fiscal control.

Turkey and Brazil typify more repressive military interventions, though with a difference in the degree of institutionalization of military rule. The Turkish military stated clearly its intention to return the country to democratic rule when it intervened in 1980; moreover, the promise was generally credible, given that the military had intervened briefly in Turkish politics before. The military's main objective was to put an end to the escalating social violence which had claimed over 5000 lives in the late 1970s. This program included an effective ban on union activity and the arrest of thousands of activists from both right-wing and left-wing groups, with well-documented instances of torture and other human rights abuses. Though the motive for these actions was as much political as economic, it fit with the government's strong commitment to stabilization and structural adjustment. The military provided the political space for a team of technocrats to continue the reforms that had been initiated under the weak and divided coalition government of Suleiman Demirel.

While Turkey's adjustment program was launched under civilian auspices, the Goulart government in Brazil appeared unable to formulate any coherent economic policy. Brazil's military intervention also proved more institutionalized. Otherwise, the pattern in the two countries is remarkably similar: a harsh stabilization introduced immediately following the military's intervention, followed by some relaxation as the military sought to exit politics. It is interesting to note that in both of these cases, inflationary pressures resurfaced as the military liberalized politics, in Turkey in 1983, in Brazil, in a more extended process after 1975.

The most radical economic experiments came in Chile under Pinochet and Argentina in the late-1970s, also the two cases in which both popular sector mobilization and subsequent repression of labor were the most intense. In these cases, militaries allied with neo-liberal technocrats not only to stabilize, but to introduce market-oriented reforms that went beyond those launched in Brazil and Turkey.

The Argentine experiment collapsed under the combined weight of an unsustainable exchange rate policy and the military's adventurism. This leaves Chile as the only country with a long history of high inflation that was capable of achieving relative price stability in the 1980s, and this in spite of significant fiscal burdens associated with servicing the external debt. The question is whether the conservative demand-management policies pursued under the Pinochet government will be maintained under the new democratic government or whether, as in Brazil and Turkey, the opening of the political arena will place new distributive pressures on the government. The possibilities for macroeconomic stability are enhanced by several changes, both political and economic, that took place under military rule. First, the substantial liberalization of trade, deindustrialization, and the weakening of the union movement have seriously reduced the organizational base of the left. Second, perhaps because of the economic and political shock of the Allende government and its aftermath, there is a strong consensus among the leaders of the major parties that inflation should be kept in check. Finally, there have been important institutional changes in the management of economic policy, including greater independence for the central bank, which should contribute to greater stability. Nonetheless, the capacity of the party system to prevent the polarization of distributive politics has not been tested.

These patterns naturally raise serious questions about the ability of new democracies in Argentina, Brazil and Peru to cope effectively with the hyperfinflations of the late 1980s and early 1990s. Does Costa Rica provide the basis for optimism concerning democratic stabilization of very high inflations? In 1982, the Social Democrats were returned to power with a strong majority in both the popular vote and in the Assembly. President Monge instituted strict foreign exchange controls, but coupled them with very tight budget policies and an appreciation of the exchange rate that cut inflation. The program was supported by the IMF from late 1982 on and by concessional American assistance on a very large scale. Inflation came down more rapidly than IMF targets. The case seems to suggest that democratic stabilization of high inflations is possible where incoming governments exploit electoral honeymoons, broad public disenchantment with the policies of the previous regime, and substantial external support to launch comprehensive programs.

Yet even a cursory look at this case reveals that the circumstances surrounding its success are very different than in the other high inflation democracies. Costa Rica was the only case of very high inflation in a democracy where party politics had not become seriously polarized. Inflation had not been a long-term phenomenon, so there were fewer problems with indexation or the credibility of government policy. Finally, the country received external assistance that was much larger relative to GNP than Argentina, Brazil, or Peru could expect to enjoy.

We close with two possible sources of hope for the democracies experiencing very high inflation. The first is that as inflation accelerates, public opinion may be more receptive to very strong measures, regardless of their distributive implications. This is suggested not only by the strong support for the Monge program, but also by apparent support within the Chilean public for Pinochet's anti-inflationary achievements. Quite harsh stabilization programs announced by both Menem and Collor also enjoyed substantial honeymoons, though the prospects of success in these two cases remain very uncertain.

Finally, there is hope that as electoral competition becomes institutionalized in countries like Argentina, Brazil and Peru, it will extend the time horizons of both political elites and competing distributive groups. In the newer democracies, the second and third round of elections have brought governments to power that favored relatively conservative economic programs; this is not simply a function of economic circumstance, but of political learning. As experiences in Costa Rica, Colombia, and Venezuela suggest, democratic compromises on stabilization issues might well be more enduring than the "solutions" imposed--and re-imposed--by successive authoritarian governments, only to be undermined by their successors.

Yet as we have argued, this result is likely to hinge on the institutional arrangements for managing political conflict. If continued economic stagnation contributes to a polarization of politics in the new democracies, the prospects for democratic adjustment must be considered poor.

END NOTES

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1. Rudiger Dornbusch and Sebastian Edwards, "The Macroeconomics of Populism in Latin America," World Bank Policy, Planning and Research Working Papers #316, December 1989; Jeffrey Sachs, "Social Conflict and Populist Policies in Latin America," NBER Working Paper, March 1989.

2. See for example, Lance Taylor, Structuralist Macroeconomics: Applicable Models for the Third World (New York: Basic Books, 1983), ch. 11.

3. See Dani Rodrik, "Liberalization, Sustainability and the Design of Structural Adjustment Programs," Kennedy School of Government Discussion Paper Series #177D, March 1989.

4. Albert Hirschman, "Reflections on the Latin American Experience," in Leon Lindberg and Charles S. Maier, The Politics of Inflation and Stagnation (Washington D.C.: The Brookings Institution, 1985), pp. 57-58.

5. We recognize that these organizational effects may interact in complex ways with the political orientation of the government in power. See for example R. Michael Alvarez, Geoffrey Garrett and Peter Lange, "The Political Economy of Macroeconomic Performance: the Advanced Industrial Democracies, 1967-1984," paper prepared for the annual meetings of the American Political Science Association, Atlanta GA, August 30-September 3, 1989.

6. Labor strength can also result in inflationary pressures indirectly through an additional mechanism: indexation. Indexation reduces opposition to inflation, and increases the vulnerability of the economy to exogenous price shocks.

7. The monetization of fiscal deficits can contribute to inflation through an indirect route as well. Where exchange rates are fixed, sometimes in the effort to post a "nominal anchor" to the economy, overvaluation can result. When the exchange rate is subsequently devalued, it can exacerbate inflation. For a comparison of the fiscal and exchange rate approaches to inflation, see Peter Montiel, "Empirical Analysis of High-Inflation Episodes in Argentina, Brazil, and Israel," IMF Staff Papers 36, 3 (September 1989), 527-549.

8. Mancur Olson, The Rise and Decline of Nations (New Haven: Yale University Press, 1982).

9. See Jeffrey D. Sachs, "External Debt and Macroeconomic Performance in Latin America and East Asia," Brookings Papers on Economic Activity 1985, 2: 523-573; Jeffrey Sachs, "Social Conflict and Populist Policies in Latin America," National Bureau of Economic Research Working Paper No. 2897 (March 1989); Stephan Haggard, Pathways from the Periphery: the Politics of Growth in the Newly Industrializing Countries (Ithaca: Cornell University Press, 1990), ch. 9.

10. Several objections can be raised against this expectation. First, a number of critics have noted that such a Philipps curve trade-off may not exist even in the short-run. Second, inflation may tax the poor relatively more heavily than the rich. Inflation is a tax on money balances, and the poor are more likely to hold a greater share of income in the form of cash. The wealthy, by contrast, are better able to shelter income through their access to a diverse range of financial instruments. In the absence of full indexation, inflation also erodes real wages, the main source of income for the poor.

11. The original statement of this perspective is William Nordhaus, "The Political Business Cycle," Review of Economic Studies 42: 169-190. For an empirical treatment with reference to the developing countries, Barry Ames, Political Survival: Politicians and Public Policy in Latin America (Berkeley: University of California Press, 1987). The rational expectations literature has made the assumption of myopic voters and a Phillips-curve tradeoff controversial. For a critique along these lines, see Brian Barry, "Does Democracy Cause Inflation? Political Ideas of Some Economists," in Leon N. Lindberg and Charles S. Maier, The Politics of Inflation and Economic Stagnation (Washington D.C.: The Brookings Institution, 1985). For attempts to defend the expectations-augmented Phillips curve, see Robert E. Lucas, Jr., "An Equilibrium Model of Business Cycles," Journal of Political Economy 83, 6 (December 1975), pp. 1113-44; Stanley Fischer, "Long-term Contracts, Rational Expectations, and the Optimal Money Supply Rule," Journal of Political Economy, 85, 1 (February 1977), 191-206. For a discussion of several models of the political business cycle that attempt to incorporate rational expectations, see Alberto Alesina, "Politics and Business Cycles in Industrial Democracies," Economic Policy 9 (April 1989), 63-4 and William Nordhaus, "Alternative Approaches to the Political Business Cycle," Brookings Papers on Economic Activity 2 (1989) 1-68.

12. For a further analysis of the constraints on new democratic governments, see Stephan Haggard and Robert Kaufman, "Economic Adjustment in New Democracies," in Joan Nelson, ed., Fragile Coalitions: The Politics of Economic Adjustment (New Brunswick: Transaction Books, 1989).

13. For theoretical attempts to model why changes of government are likely to result in macroeconomic instability, see Alberto Alesina and Allan Drazen, "Why Are Stabilizations Delayed? A Political-Economic Model," unpublished ms., and Alex Cukierman, Sebastian Edwards and Guido Tabellini, "Seignorage and Political Instability," paper presented at the NBER conference on Political Economy, May 1989.

14. This line of work was pioneered by Douglas Hibbs, "Political Parties and Macroeconomic Policy," American Political Science Review 71 (December 1977), 146-187. For reviews, see James E. Alt and K. Alec Chrystal, Political Economics (Berkeley: University of California Press, 1980), 103-125; Douglas A. Hibbs, Jr., The American Political Economy (Cambridge: Harvard University Press, 1987), 213-232; Alesina, "Politics and Business Cycles in Industrial Democracies"; Nordhaus, "Alternative Approaches to the Political Business Cycle."

15. See Robert Lacey, "The Management of Public Expenditures: An Evolving Bank Approach," The World Bank, Policy, Planning and Research Working Paper No. 46, January 1989; John T. Woolley, Monetary Politics: The Federal Reserve and the Politics of Monetary Policy (Cambridge: Cambridge University Press, 1984).

16. This effect is emphasized in Alberto Alesina, "Macroeconomic Policy in a Two-Party System as a Repeated Game," Quarterly Journal of Economics 1987; Alesina and Drazen, "Why are Stabilizations Delayed?"

17. Identifying an "episode" is difficult, since inflation may creep upward for a number of years before finally crossing an arbitrary dividing line, or may cross the threshold and remain at a constant, but higher level. We have grouped together those years when the rate of inflation increased without interruption into a single episode, based of the highest annual inflation rate reached. Similarly, we group together all years of stable, but higher inflation as a single episode. (See Appendix 1)

A second problem is that crossing an artificial threshold may not be viewed by authorities as constituting a policy problem, while changes within categories may be. Moreover, in selecting and analyzing cases, it is essential to be attentive to the rates of change of inflation as well as inflation itself. An increase in the rate of inflation from five to ten percent may be as explosive for a society accustomed to stable prices as a change from 50 percent to 100 percent in a country that has lived with rapid price increases for long periods of time. We believe that we have captured all of the relevant inflation/stabilization episodes through our strategy, but in gauging the political and policy significance of price increases, there is no substitute for the analysis of the perceptions of decision-makers.

18. See William R. Easterly, Fiscal Adjustment and Deficit Financing During the Debt Crisis, Policy, Planning and Research Working Paper #138, The World Bank, January 1989.

19. See Max Corden, "Exchange Rate Policy in Developing Countries," unpublished ms, The World Bank, February 1990.

20. For an overview of the issues, see Nicolas Ardito Barletta, Mario I. Blejer and Luis Landau, eds., Economic Liberalization and Stabilization Policies in Argentina, Chile, and Uruguay (Washington D.C.: The World Bank, 1984); John Williamson, Inflation and Indexation: Argentina, Brazil and Israel (Washington D.C.: Institute of International Economics, 1987); Peter Montiel, "Empirical Analysis of High-Inflation Episodes."

21. Rudiger Dornbusch and Sebastian Edwards, "The Macroeconomics of Populism in Latin America," Policy, Planning and Research Working Paper #316, The World Bank, December 1989; Jeffrey D. Sachs, "Social Conflict and Populist Policies in Latin America," National Bureau of Economic Research Working Paper No. 2897, March 1989.

22. For a review, see John Williamson, ed., Inflation and Indexation: Argentina, Brazil, and Israel (Washington: Institute for International Economics, 1985).

23. This is particularly true for hyperinflations, and a large technical literature has emerged on them, though we do not address it here. The following draws on Rudiger Dornbusch, "Mexico: Stabilization, Debt and Growth," in Economic Policy 7 (October 1988), pp. 251-262.

24. See Thomas E. Skidmore, "The Politics of Economic Stabilization in Postwar Latin America," in James Malloy, ed., Authoritarianism and Corporatism in Latin America (Pittsburgh: University of Pittsburgh Press, 1977); John Sheahan, "Market-oriented Policies and Political Repression in Latin America," Economic Development and Cultural Change 28, 2 (1980): 267-291; Karen Remmer, "The Politics of Economic Stabilization: IMF Standby Programs in Latin America, 1954-1984," Comparative Politics 19 (October 1986), 1-25; Stephan Haggard, "The Politics of Adjustment: Lessons from the IMF's Extended Fund Facility," in Miles Kahler, ed., The Politics of International Debt (Ithaca: Cornell University Press, 1986); and the review of the literature in Haggard and Kaufman, "The Politics of Stabilization and Structural Adjustment," in Jeffry Sachs, ed., Developing Country Debt and Economic Performance (Chicago: Chicago University Press, 1989), pp. 232-239.

Appendix 1
Inflation Episodes

The inflation episodes are derived on the basis of the following criteria:

a. Years when inflation (CPI) for the whole year crossed the threshhold and all following years that it stayed roughly constant with no evidence of stabilization;

b. For the "high" and "very high" inflation cases, all years prior to the highest annual level of inflation that are marked by an increase in inflation above the respective threshold;

c. Within the "very high" inflation category, episodes are differentiated if inflation is reduced significantly, but remains above the 90 percent threshold, and then increases again.

Country	Years of Episode	Inflation in prior year	Peak inflation (year)
MODERATE INFLATIONS			
Threshold: 15 percent			
N=23			
Range: 15.7 - 29.5			
Korea	1970	12.5	16.1 (1970)
Malaysia	1974	10.5	17.4 (1974)
Philippines	1979-80	7.3	18.2 (1980)
Indonesia	1978-79	6.7	18.2 (1978)
Taiwan	1960	10.6	18.4 (1960)
Taiwan	1980	9.8	19.0 (1980)
Peru	1965-68	9.1	19.0 (1968)
Colombia	1966	3.5	19.1 (1966)
Turkey	1971-76	6.1	19.2 (1975)
Thailand	1980	9.9	19.7 (1980)
Philippines	1970-71	1.3	21.4 (1971)
Venezuela	1979-81	7.1	21.5 (1980)
Brazil	1952-56	10.8	21.8 (1956)
Peru	1973-75	7.2	23.6 (1975)
Colombia	1985-87	16.1	24.0 (1985)
Thailand	1973-74	4.9	24.3 (1974)
Korea	1974-75	3.2	25.3 (1975)
Jamaica	1973-75	5.0	27.2 (1974)
Jamaica	1984-85	11.6	27.8 (1984)
Venezuela	1987	11.5	28.1 (1987)
Korea	1979-80	14.5	28.7 (1980)
Mexico	1974-77	12.0	29.0 (1977)
Korea	1963-64	6.7	29.5 (1964)

HIGH INFLATION
Threshold: 30 percent
N=21
Range 30.1 - 84.0

Costa Rica	1973-75	4.6	30.1 (1974)
Argentina	1962-67	14.0	31.7 (1966)
Colombia	1963	2.7	32.0 (1963)
Colombia	1973-82	13.1	33.1 (1977)
Chile	1968-70	18.8	33.0 (1970)
Chile	1958-59	17.3	33.3 (1959)
Chile	1967-70	17.0	34.9 (1970)
Philippines	1973-74	8.2	34.2 (1974)
Jamaica	1978-80	11.2	34.9 (1978)
Argentina	1949-52	13.0	38.1 (1952)
Uruguay	1959-60	6.0	39.5 (1959)
Indonesia	1972-73	4.4	40.6 (1973)
Chile	1962-64	9.6	45.3 (1963)
Taiwan	1974	8.2	47.5 (1974)
Philippines	1984	8.3	50.3 (1984)
Brazil	1959	17.3	51.9 (1959)
Brazil	1974-79	12.7	52.7 (1979)
Argentina	1971-73	13.6	61.2 (1973)
Peru	1976-81	23.6	75.4 (1981)
Uruguay	1983-86	19.0	76.4 (1986)
Chile	1953-55	12.0	84.0 (1955)

VERY HIGH INFLATION
Threshold: 90 percent
N=14
Range: 90.1 - 1044.8

Costa Rica	1981-83	18.1	90.1 (1982)
Brazil	1962-64	32.3	91.4 (1964)
Uruguay	1972-75	24.0	97.0 (1973)
Turkey	1977-80	17.4	110.2 (1980)
Argentina	1958-59	13.1	113.9 (1959)
Uruguay	1964-68	21.3	125.3 (1968)
Mexico	1983-87	27.9	131.8 (1987)
Peru	1983-85	64.4	163.4 (1985)
Brazil	1981-87	19.1	227.7 (1987)
Argentina	1987	145.2	229.7 (1987)
Argentina	1975-76	23.5	443.2 (1976)
Chile	1972-74	19.2	504.7 (1974)
Argentina	1982-85	104.5	672.1 (1985)
Indonesia	1962-66	30.7	1044.8 (1966)

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